No. 11,823

In the United States Court of Appeals for the Ninth Circuit

LEO M. HARVEY AND LENA P. HARVEY, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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CITATIONS

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OPINION BELOW

The finds of fact and opinion of the Tax Court (R. 42-50) are not officially reported.

JURISDICTION

This petition for review (R. 59-65) involves federal income taxes for the taxable years 1939, 1940 and 1941. On November 17, 1944, the Commissioner of Internal Revenue mailed to each of the taxpayers a notice of deficiency in the total amount of $15,651.84. (R. 19.) [1] Within ninety days thereafter, and on February 12, 1945, the taxpayers filed the petitions with the Tax Court for redetermination of those deficiencies under

[1] The pleadings in the Lena P. Harvey case were omitted from the record. (R. 125.)

the provisions of Section 272 of the Internal Revenue Code. (R. 10-29.) The decisions of the Tax Court sustaining the deficiencies were entered July 17, 1947. (R. 57-59.) The case was brought to this Court by a petition for review filed October 17, 1947 (R. 59-65), pursuant to the provisions of Section 1141 (a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

QUESTIONS PRESENTED

(1) Did the Tax Court err in determining that the sale of the patents here involved was not a sale of capital assets under Section 117 (a) (1) of the Internal Revenue Code and was therefore productive of ordinary income?

(2) Did the Tax Court properly determine that taxpayer had failed to prove that his son had rendered any valuable services in connection with the sale so as to justify the exclusion from the sales price of the sum of $85,000 paid by taxpayer to his son for services allegedly rendered?

(3) Did the Tax Court properly determine that there was no evidence to indicate that taxpayer's brother had any property interest in the patents?

(4) Did the Tax Court err in denying taxpayer's motion for a judgment on the pleadings?

STATUTE AND REGULATIONS INVOLVED

The statute and Regulations involved may be found in the Appendix, *infra.*

STATEMENT

The formal findings of fact of the Tax Court (R. 43-46) are set out as follows:

Taxpayers are husband and wife residing in Los Angeles. Unless otherwise indicated "taxpayer" will

hereinafter refer to the husband, Leo M. Harvey. (R. 43.)

By written agreement dated March 21, 1938, taxpayer sold certain patents and applications for patents, both foreign and domestic, to the Gerrard Company, Inc., hereinafter referred to as Gerrard. The patents so sold by taxpayer covered inventions in the round wire tying and the flat band strapping and tying fields. As here material, Gerrard paid as consideration $25,000 cash upon execution of the agreement and delivered to taxpayer ten negotiable promissory notes, each in the amount and each having then a fair market value of $40,000, all dated April 2, 1938, numbered one to ten, inclusive, and maturing serially commencing April 2, 1939, and thereafter on April 2 of each succeeding year through April 2, 1948. These notes were tendered and accepted as payment. During the taxable years here involved these notes were paid when due. (R. 43.)

By written agreement and under circumstances hereinafter described taxpayer paid his son Lawrence twenty per cent of the proceeds of the sale as received by taxpayer. Taxpayer also paid certain amounts to his brother Herbert from such proceeds. Herbert was thus paid $2,500 in each of the taxable years here involved. (R. 43-44.)

In reporting the proceeds of the sale for income tax purposes taxpayers excluded or deducted from the sales price certain amounts on account of such obligations or payments to Lawrence and Herbert. The remainder of the sales price was reported on the installment basis and treated as capital gain, each taxpayer reporting a community one-half. Thus, taxpayers reported as taxable gain to be taken into account from the sale the amount of $15,828.72 for each of the taxable years here involved, each taxpayer reporting a

community half thereof, or $7,914.37.[2] The Commissioner determined that the entire proceeds received constituted ordinary income to taxpayers and not capital gain. The Commissioner in this connection stated (R. 44):

> It is determined that the entire $40,000.00 received in each year is taxable as ordinary income. Your community share of this income has accordingly been increased in each year by the amount of $2,085.63 from the $7,914.37 (total reported as above) to $20,000.00.

Taxpayer's son, Lawrence, was an attorney about twenty-eight years old in 1938. He assisted taxpayer in negotiating the sales contract with Gerrard. Taxpayer agreed in writing dated April 2, 1938, to compensate Lawrence for his efforts in this connection by paying twenty per cent of all proceeds of the sale as received by taxpayer. Under this agreement taxpayer paid Lawrence $8,000 a year during the taxable years. Taxpayer also employed as attorneys in connection with the Gerrard deal, Max Schlesinger, who handled the tax aspects, one Rubin and a Walter Sheldon. Walter Sheldon was paid $22,500 in 1938 by taxpayer for his services, which services among others included Sheldon's work in connection with the Gerrard sale. (R. 45.)

Taxpayer's brother, Herbert, had been an employee of taxpayer since about 1918 on a salary ranging from $500 to $1,500 a month. Taxpayer, since about 1914, had been sole proprietor of a business known as Harvey Machine Company. This business consisted primarily of making industrial machinery on special order. Herbert was employed in connection with this business. (R. 45.)

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[2] The figure of $7,914.37 was the one actually reported rather than $7,914.36.

Taxpayer with the advice and assistance of Herbert had commenced developing inventions in the wire tying field in the middle 1920's and subsequent thereto and from time to time obtained the patents sold to Gerrard. The expenses of developing these inventions were deducted as business expenses of Harvey Machine Company. Some time in 1930 taxpayer licensed Gerrard to operate under certain of the flat wire tying patents at a minimum royalty of $30,000 a year, which taxpayer received from 1931 to 1937, inclusive. In 1938 and by the terms of the sales contract Gerrard agreed to pay taxpayer certain amounts on account of royalties due up to and including March 31, 1938. These royalty payments were reported by taxpayer as income from the business of Harvey Machine Company. Taxpayer had paid Herbert ten per cent of the $30,000 annual minimum royalty received by taxpayer from Gerrard. The sales contract with Gerrard stated that it was understood between the parties that the patents involved and referred to as owned by taxpayer included not only those owned by taxpayer but "also patents, patent applications and inventions, if any, owned by Herbert Harvey * * *." (R. 45-46.)

The Tax Court found further in its opinion (R. 46-50) that the patents were used in taxpayer's business, as an inventor, and were subject to depreciation; that taxpayer had failed to sustain the burden of proving that his son had rendered any valuable services in connection with the sale; and that taxpayer had failed to sustain the burden of proving that his brother had any property interest in the patents, or that payments to his brother were deductible or excludible from the sale price.

SUMMARY OF ARGUMENT

The patents sold clearly constituted property used in the trade or business of a character subject to depreciation, and as such were excluded from the definition of "capital assets" under Section 117 (a) (1) of the Internal Revenue Code. The evidence amply supports the Tax Court's determination that taxpayer was engaged in the business of developing and patenting inventions. It is indisputable that the patents were subject to depreciation. Where in the course of business a taxpayer devotes property to rental purposes and to the production of taxable income, the property is used in the trade or business. Whether or not the patents were used in the trade or business of taxpayer was a question of fact, and since the Tax Court's determination was not clearly erroneous it should be upheld. From the record it is manifest that the Tax Court correctly held that taxpayer had failed to sustain his burden of proving that his son had rendered any valuable services in connection with the sale. This being so, taxpayer was not entitled to an exclusion from the sale price for any sum paid his son, far less the sum of $85,000. There is no evidence in the record to indicate that taxpayer's brother had any property interest in the patents or rendered any services in connection with the sale so as to justify an exclusion in any amount from the sale price. Taxpayer's brother had been adequately compensated for all services rendered during prior years in the development of the patents, and these services were rendered by him as an employee. Taxpayer's contention that judgment on the pleadings should have been rendered is completely lacking in merit since the real issues in the case were primarily disputed issues of fact.

ARGUMENT

I

The Tax Court properly held that the patents sold were not capital assets under Section 117 (a) (1) of the Internal Revenue Code

Section 117 (a) (1), Appendix, *infra,* excludes from the term "capital assets" any property which is "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in Section 23 (1)." The conclusion seems unavoidable that the flat band patents sold here were utilized for the production of income in taxpayer's business, and were thus not capital assets.

Taxpayer's testimony as to the number of years involved in the development of the flat band patents was ambiguous. His testimony indicates that he first gave thought to the problem of developing a wire tying device around 1924 or 1925 (R. 86), and that the earliest patent for a flat band wire tying machine was obtained on July 17, 1928 (R. 101). At the time of the sale, a large number of flat band patents had been obtained by taxpayer. (R. 73.) The first rights to operate under these patents were assigned to the Tying Machines Company for an undisclosed consideration. (R. 101.) Subsequently, the Gerrard Company bought out the Tying Machines Company, and a royalty agreement was consummated whereby the Gerrard Company paid to the taxpayer a yearly $15,000 royalty on the foreign flat band patents and a similar royalty on the domestic flat band patents; and these payments were continued until the time of the sale. The general rule has often been reiterated that where the owner of depreciable property devotes it to rental purposes and

to the production of taxable income, the property is used by him in a trade or business. *Vosburgh* v. *Commissioner,* 23 B. T. A. 780; *Kimbell* v. *Commissioner,* 41 B. T. A. 940; *Fackler* v. *Commissioner,* 45 B. T. A. 708, affirmed, 133 F. 2d 509 (C.C.A. 6th). As early as 1911, the Supreme Court held that a corporation which owned and leased taxicabs and collected the rents therefrom was "carrying on or doing business" within the meaning of the Corporation Excise Tax Act of 1909, c. 6, 36 Stat. 11, 112, Sec. 38. *Flint* v. *Stone Tracy Co.,* 220 U. S. 107.

Taxpayer contends, however, that the mere passive receipt of rentals cannot be considered as operating business; and further that the patent activities were not connected with his business, which was the manufacture of machines on special order. Apparently taxpayer would ignore the years of effort and the funds consumed in the development of the patents which ultimately brought a yearly royalty of $30,000, and a sales price of $425,000. Apart from the time spent on the development of the original flat band patents, under the agreement with Gerrard, taxpayer agreed to complete certain work in connection with pending applications. (R. 83.) Indeed, the very first models made under the flat band patents for the Gerrard Company were made by taxpayer. (R. 82.) Thus, even if it were true that taxpayer's only business was the manufacture of machines on special order, it would be clear that the flat band patents were used in taxpayer's trade or business.

The record is, however, replete with evidence which supports the finding of the Tax Court that taxpayer was engaged not only in the business of manufacturing but also in the business of developing and patenting inventions for the production of income. In addition to the flat band patents, taxpayer developed and secured pat-

ents on round wire tying devices, a paper dispenser, a part of a washing machine, and a device for cutting oranges. (R. 88, 92, 93.) Taxpayer testified that "maybe there were more." (R. 93.) Taxpayer admitted that there were a large number of other devices to which he devoted some time and which did not result in the procurement of a patent. (R. 94.) He further testified that when he began developing these ideas, it was the practice to construct models and make drawings. (R. 88.) Again, taxpayer's testimony was not clear as to the period of time devoted to his inventive activities, but the record as a whole supports the inference that it was considerable. Taxpayer testified, for example, that he first began work on round wire tying devices in 1927 and that he was still working on them as late as 1935. (R. 99.) At least on one return, taxpayer stated his occupation to be proprietor of a machine shop and inventor. (R. 112.) The royalty income obtained from the patents here involved was included in the business income on taxpayer's returns. (R. 112-115.) The expenses incurred by taxpayer in connection with his development of the several patents were deducted as business expenses. (R. 94-95.)

Moreover, the reasons suggested by the taxpayer for his development of patents indicate that they were developed for use in taxpayer's business. He testified that patents were developed so that they would "help us in making the article, nobody else will encroach on * * *." (R. 90.) Taxpayer testified further that in developing patents he considered the possibility of obtaining royalties from them. (R. 91.) Whether taxpayer developed patents so that he might thereby obtain an exclusive right to manufacture the devices himself, or whether he developed them for the production of royalty income, the patents were used for the production of income in taxpayer's trade or business. Nor

were the flat band patents the only patents disposed of for a consideration. The right to utilize taxpayer's round wire patents had been assigned to the Gerrard Company for a consideration which taxpayer could not recall; and all the round wire tying devices were sold in 1938. (R. 100.) The patents pertaining to washing machines were also transferred to another corporation for a consideration which taxpayer could not recall. (R. 102-103.)

Although it is true that taxpayer testified that he developed inventions because he enjoyed doing so, it is manifest that the enjoyment of pleasure or recreation from an undertaking cannot change its character from a business to a hobby. Whether taxpayer's inventive activities were carried on as a business or as a hobby was a question of fact to be determined by the Tax Court, as was the question of whether the patents here involved were utilized in taxpayer's trade or business. *Greene* v. *Commissioner,* 141 F. 2d 645 (C. C. A. 5th) certiorari denied, 323 U. S. 717. Since the scope of review over decisions of the Tax Court is now the same as that exercised over judgments of the District Courts in non-jury cases, the findings of the Tax Court may not be reversed unless clearly erroneous. Section 36, Public Law 773, 80th Con., 2d Sess., approved June 25, 1948. The evidence here amply supports the Tax Court's determination that the patents sold were utilized for the production of income in taxpayer's trade, as an inventor. Since it is indisputable that the patents were subject to depreciation under Section 23 (1) and Treasury Regulations 103, Sec. 19.23(1)-7, Appendix, *infra,* the patents were excluded from the term "capital assets" under Section 117 (a) (1), and the sale of the patents was productive of ordinary income.

In *Fackler* v. *Commissioner, supra,* the Board of Tax Appeals held that a leasehold was property used in a

trade or business within the meaning of Section 117 (a) (1), where taxpayer devoted all his business hours to his profession, as an attorney, and only one or two hours a month to the leasehold premises. The decision was upheld by the appellate court, which pointed out that whether property is used in a trade or business is an ultimate fact for the trial court, whose finding will be sustained if supported by the evidence. In the instant case, there is far more evidence than in the *Fackler* case from which the Tax Court could have concluded that taxpayer's activities in developing and patenting devices for the production of income constituted the carrying on of a business.

The facts in the instant case are strikingly similar to those in *Smythe* v. *Commissioner,* decided June 25, 1942 (1942 P-H B. T. A. Memorandum Decisions, par. 42,377), in which the Board of Tax Appeals stated:

> Assuming this, we think it follows that the subject matter of the sale both was depreciable property used by petitioner in his trade or business, and that it had been held for sale to customers in the regular course of that business. For petitioner gives his occupation as that of an inventor. He deducts and has been allowed, as business expense, payments made in connection with that occupation. We cannot say that this is not a "trade or business," nor, if it is, that the fruits of inventive genius are other than the stock in trade of that business. Their conversion into gain or profit measured in monetary terms would most typically take the form of a sale or license of the idea resulting and of the exclusive privilege to the use of that idea conferred by the protection of the patent law. Here petitioner resorted to both types of the realization of gain. He issued a license calling for the payment to him of a stipulated fee and ultimately made his invention the subject of a sale. These circumstances satisfy us that under the facts as they presently appear the subject matter of the sale was not

> a capital asset as that term is defined. *John D. Fackler,* 45 BTA 708, 714. Of course, the business in which petitioner was engaged is the very essence of this reasoning.

Taxpayer's entire argument on this issue is directed toward an attempt to prove that the flat band patents were not used in taxpayer's machine business. This approach indicates a misconception as to the purport of the Tax Court's decision. The Tax Court held that taxpayer was engaged also in the business of developing patents, and that these patents were utilized for the production of income in his business as an inventor.

Taxpayer (Br. 22) relies on the case of *Albright* v. *United States,* 76 F. Supp. 532 (Minn.), for the proposition that the phrase "used in the trade or business" means "used by the taxpayer in his trade or business at the time of the sale." Taxpayer's conclusion is that at least at the time of the sale, the patents were not used in his trade or business. The *Albright* case not only fails to support the taxpayer but demonstrates the weakness of his position. In the first place, in the *Albright* case, there was evidence of an actual physical conversion at or prior to the time of sale. In the instant case, the taxpayer held his patents for the production of royalty income in his business as an inventor up until the very time of sale. Depreciable business property retains its character as such even if not in use in the business at the time of sale unless it has been converted to another purpose prior thereto. *Carter-Colton Cigar Co.* v. *Commissioner,* 9 T. C. 219; *Kittredge* v. *Commissioner,* 88 F. 2d 632 (C. C. A. 2d); *Wright* v. *Commissioner,* 9 T. C. 173; *Yellow Cab Co. of Pittsburgh* v. *Driscoll,* 24 F. Supp. 993 (W. D. Pa.).

Furthermore, even if the doctrine of the *Albright* case were here applicable, it would avail the taxpayer little; for under the rationale of the *Albright* case, the

patents here involved, if not "property, used in the trade or business" at the time of the sale, would be considered as "property held by the taxpaper primarily for sale to customers in the ordinary course of his trade or business", and would for that reason be excluded from the definition of "capital assets" under Section 117 (a) (1). The *Albright* case arose under Section 117 (j) of the Internal Revenue Code which provided that a taxpayer might treat the sale of depreciable property used in the trade or business as the sale of a capital asset. This section was, of course, not in the revenue law during the calendar years here involved. In the *Albright* case it was therefore essential to determine whether certain livestock were "used in the trade or business," in which case they could be treated as capital assets, or whether they were held "primarily for sale to customers in the ordinary course of his trade or business," in which case their sale would produce ordinary income. The Government's position, which was sustained, was that the breeder of livestock who regularly sells a portion of his herd each year, has a dual motive in raising each head of livestock, use as a breeder and ultimately sale; and that at the time of the sale, the livestock were held primarily for sale. Applying the *Albright* doctrine here, we find that taxpayer developed patents for use in his business, but for ultimate disposition by sale; and in fact, that three of the five basic patents mentioned in the record were ultimately sold. It might therefore be contended that at the time of the sale, the patents were "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" and excludible from the definition of "capital assets" for that reason.

Indeed, this alternative contention was made in the Tax Court. Since there is ample evidence to support the Tax Court's finding that the patents were used in

the taxpayer's trade or business, it is not essential that we determine whether or not the patents fall within another exclusion. It can, however, be persuasively argued, in the alternative, that the patents were held "primarily for sale to customers in the ordinary course of his trade or business." There is little doubt that taxpayer had in mind the sale of some of these patents if an attractive proposition were made. Apart from the sale of the flat band patents, taxpayer did dispose of the round wire tying patents and the washing machine patents for undisclosed consideration. Undoubtedly he would have sold the other devices if a suitable opportunity arose. See *Goldsmith* v. *Commissioner,* 143 F. 2d 466 (C. C. A. 2d), certiorari denied, 323 U. S. 774.

The language utilized by the Board of Tax Appeals in *Avery* v. *Commissioner,* 47 B. T. A. 538, is particularly applicable (p. 542):

> The primary use to petitioner of the appliances and devices developed by his creative genius and the patents issued thereon was the gain to be derived from the sale or other disposition of the patents to persons or corporations to whom they were of beneficial use. What may have been a hobby originally became a trade or business when he held the patents for sale or license to others for profit. We think it is immaterial that he created no new devices or received no new patents in the year he sold the patent to the Marchant Co. Until disposed of his patents were held primarily for sale or other disposition to customers and this situation was not different during the taxable year. He not only hoped to but did realize gains or profits from his activity as an inventor and the sale or licensing of patents on devices invented by him.

There is no merit in taxpayer's contention that the sale was not in the "ordinary course of his trade or business" because it was made to obtain greater working capital. The method of financing made available to

taxpayer very little in excess of what he had been receiving as royalties. Nor was the Gerrard Company any the less a "customer" because it had been renting the patents prior to the sale. It is not, however, necessary to pursue this contention further since it is manifest that the evidence supports the Tax Court's determination that the property was used in taxpayer's trade or business.

Taxpayer introduces into his argument a novel concept as to the administration and interpretation of the revenue laws. Taxpayer, although apparently conceding that Section 117 (a) (1) of the Revenue Act of 1938, enacted shortly after the sale here involved, was, by the terms of the Act, effective January 1, 1938, and that retroactive application of the income tax laws is constitutional, nonetheless contends that all doubts as to the meaning of the law should be resolved in his favor because of the retroactivity. Taxpayer relies on *Claridge Apartments Co.* v. *Commissioner,* 323 U. S. 141. This case only reiterates the well-established principle that, where there is some doubt as to the legislative intention that a law be applied retroactively, retroactivity will not be favored. But here, the statute is made applicable by its terms to "taxable years beginning after December 31, 1937" (Revenue Act of 1938, Sec. 1); and Section 117 (a) (1) of the Act in no uncertain terms excludes from the definition of "capital assets" "property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1)."

Taxpayer makes reference to the Committee Reports (Br. 20-22), pertaining to that language of Section 117 (a) (1) which excludes from the definition of "capital assets" "property, used in the trade or business". It is clear from a cursory reading of the Committee Reports that the language was intended as a

relief measure. Congress realized that depreciable business property was often sold at a loss and that its exclusion from the definition of capital assets would permit the taxpayer the benefit of the entire loss. This however, does not justify taxpayer's conclusion that sales of depreciable business property which result in gain were not intended to be covered by the exclusion. A reading of the Committee Reports, as set out in taxpayer's brief, clearly indicate that Congress did not expect the provision to benefit the taxpayer in all cases. Not until the Revenue Act of 1942 was passed was Section 117 (j) enacted whereby taxpayers were given the option of treating the sale of depreciable business property as a capital transaction or not, as they desired. If taxpayer's contention as to the meaning of Section 117 (a) (1) of the Revenue Act of 1938 were correct, it would hardly have been necessary for Congress to enact Section 117 (j) some four years later.

The language of Section 117 (a) (1) is unambiguous. It excludes from the definition of "capital assets" depreciable property used in a trade or business. The Tax Court's finding that the patents here involved were used in taxpayer's trade or business is amply supported by the evidence. It is not, and cannot, be questioned that patents are subject to depreciation. It therefore follows that the patents were excluded from the term "capital assets" and their sale was productive of ordinary income.

The fact that taxpayer argues in conclusion that the patents were held for investment is almost an acknowledgment of the weakness of his case. Taxpayer devoted years of effort to the development of these and other patents, secured substantial royalties for their use for about a decade, reported the income thus obtained as business income and deducted the expenses attendant upon their development as business expenses, a fact in

itself completely inconsistent with the treatment of the patents as investment assets.

II

The Tax Court properly determined that the taxpayer was not entitled to deduction or exclusion of the amount paid by taxpayer to his son for services allegedly rendered

Taxpayer's claim that he was entitled to an exclusion from the sales price of the patents in the amount of $85,000 was naturally subject to close scrutiny by the Commissioner in view of the fact that the payment was of extraordinary size and was made to taxpayer's son for services of nebulous character. The Commissioner, having determined that the services performed by taxpayer's son, Lawrence Harvey, were of no substantial value, the burden was, of course, on the taxpayer to overcome the presumption in favor of the validity of this determination. The Tax Court found that taxpayer had failed to sustain the burden, and properly so, for the evidence offered by taxpayer fell far short of proving that Lawrence Harvey rendered any services which would entitle him to share in the proceeds of the sale.

By written contract dated subsequent to the contract of sale, taxpayer agreed to pay his son, a twenty-eight year old attorney, twenty per cent of the proceeds of the sale, or the sum of $85,000, for services allegedly rendered in connection with the sale. The services recited in the contract were assistance in the negotiation and preparation of contracts and notes. (R. 123.) Taxpayer testified that he had an accountant and two other attorneys working on the transaction; and that one of the attorneys, Walter Sheldon, advised as to the method of handling the transaction. (R. 104.) He testified that his son was not hired in his capacity as a lawyer to draw contracts and that he had never repre-

sented taxpayer in the sale of patents. (R. 108.) At least one other attorney, Mr. Walter Sheldon, was paid a substantial attorney's fee in the year 1938. (R. 108.)

In answer to the query as to the exact nature of the services performed by Lawrence Harvey, taxpayer replied: "Well, he negotiated with people". (R. 108.) The unsatisfactory nature of the evidence adduced at the trial would not support a finding that taxpayer's son was entitled to any share in the proceeds of the sale, much less the fabulous sum of $85,000.

Taxpayer contends that since an expense in connection with a sale is an exclusion rather than a deduction, the standard for determining the validity of the exclusion is whether it is bona fide, not whether it is ordinary, necessary and reasonable. It is hardly necessary to take issue with this proposition. The question of the reasonableness of the payment of $85,000 to taxpayer's son and the bona fides of the transaction are not disassociated. Indeed, the payment of the sum of $85,000 for the elusive services performed would indicate that the payment had its basis in the relationship between father and son, rather than in the performance of services, and that the exclusion was not bona fide.

Taxpayer argues that although Lawrence Harvey was only twenty-eight, many of the greatest accomplishments have been made by young men such as Keats, Einstein and Hutchins. Whether those men ever obtained $85,000 for such intangible services as here is open to question. At any rate, no basis was laid for the comparison. Lawrence Harvey was available as a witness, but did not take the stand. The evidence did not indicate that he had any special qualifications.

Taxpayer's contention that the Tax Court was bound to make some valuation of the services rendered by Lawrence is untenable. Cases cited by taxpayer are inapplicable. In *Helvering* v. *Taylor,* 293 U. S. 507,

515, the Supreme Court held only that, where the taxpayer's evidence shows the Commissioner's determination to be "arbitrary and excessive," the taxpayer is not bound "to pay a tax that confessedly he does not owe" because the evidence is not sufficient to establish the correct amount. In *Cohan* v. *Commissioner,* 39 F. 2d 540 (C. C. A. 2d), again it was conceded that taxpayer was entitled to the deduction involved, and the Board of Tax Appeals had refused to make an evaluation because it could not determine the exact amount with certainty. *W. D. Haden Co.* v. *Commissioner,* 165 F. 2d 588 (C. C. A. 5th), similarly involved a situation where, as a matter of law, taxpayer was entitled to a deduction.

The Commissioner here determined that Lawrence rendered services of no substantial value. The determination was reasonable. It is true that the Tax Court stated in its opinion that Lawrence rendered some assistance to the taxpayer, but the Tax Court did not conclude that the assistance was substantial or valuable. Indeed, the Tax Court described the services as "nebulous." The record supports the conclusion that Lawrence rendered no services of value. Taxpayer cannot expect the Tax Court to carry his burden of proof. This Court in *Hughes* v. *Commissioner,* 104 F. 2d 144, held that where a taxpayer submitted no evidence of value, the refusal of the Board of Tax Appeals to permit taxpayer to adduce additional evidence was not an abuse of discretion where the reason may have been that such evidence was available in ample time to present it to the Board before it made and filed its findings of fact and opinion. There too, taxpayer relied on *Helvering* v. *Taylor, supra,* and this Court said (p. 148):

> That case is not in point here because the taxpayer had not shown that his interest in the trust

had a value. * * * In the absence of proof of the value, the rule in *Helvering* v. *Taylor,* 293 U. S. 507, * * * is not applicable, because it is not shown that the Board's decision was wrong.

III

The Tax Court properly determined that taxpayer had failed to prove that his brother had any property interest in the patents

The only question for the Tax Court in this connection was whether Herbert Harvey, taxpayer's brother, had any property interest in the patents sold so as to justify the exclusion from the sale price of any sum due Herbert Harvey. The Commissioner determined that Herbert Harvey had no such interest. The record is devoid of any evidence indicating that Herbert Harvey had any interest in the property or performed any services in connection with the sale. Admittedly, Herbert performed services in the development of the patents, but during that period he was in the continuous employ of taxpayer. (R. 97.) Herbert's compensation during this period varied from $500 to $1,500 a month. (R. 98.) The fact that he worked on the patents and that part of his compensation was paid out of the royalties does not indicate that he had any property interest in them. Nothing in the record shows that any of the patents were in Herbert's name. The contract of sale provided that Herbert Harvey disposed of his interest in the patents, *if any.* (R. 121.) There was no evidence to indicate that there was any oral agreement between taxpayer and Herbert acknowledging that the latter had any property interest in the patents. Although taxpayer's counsel put the question to the taxpayer directly, taxpayer did not testify that any property interest in the patents was acknowledged as belonging to his brother. (R. 80.) The record would indicate that Herbert had been adequately compensated for any services rendered

in prior years. The Tax Court properly held that the Commissioner's determination in this connection must also be sustained because taxpayer "failed to establish the payments to Herbert as either exclusions or deductions from the sales price." (R. 49.) Nor was the Tax Court bound to afford the taxpayer a second opportunity to adduce the evidence necessary to sustain his burden after its findings and opinion had been filed. *Hughes* v. *Commissioner, supra.*

IV

The Tax Court did not err in denying taxpayer's motion for a judgment on the pleadings

Taxpayer's contention that judgment on the pleadings should have been rendered for him is not only lacking in merit, but would, if sustained, subvert the drawing of pleadings to a game of mental gymnastics between counsel, having as its objective the entrapment of opposing counsel.

Stripped of the superfluous, taxpayer's contention may be restated as follows: Taxpayer, in his petition, by way of negative allegation, denied that the patents were "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business", similarly denying the applicability of the other exceptions to the definition of "capital assets." As should be expected, under the circumstances of the case, the Commissioner in his answer entered denial to these negative allegations, in order to put the taxpayer to proof. Taxpayer contends that the denial of his negative allegation was the equivalent of an affirmative allegation by the Commissioner that the property was "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business"; and that by implication the Commissioner alleged that the sale was therefore not "casual." Taxpayer concludes

that all of the income would have been taxable in the year of sale and none of it would be taxable in the years here involved, except for the fact that the sale being "casual" under Section 44 (b) (Appendix, *infra*), the profits could be treated on the installment basis; and that therefore the Commissioner's denial amounted to an admission that no tax was due in the taxable years here involved.

Taxpayer, in making this contention, misconceives the basic purpose of pleadings. When the Commissioner denied taxpayer's negative allegation he did so in order to put the taxpayer to proof. It was not necessarily intended to allege the affirmative; and it was certainly never intended to allege impliedly or otherwise that the sale was or was not "casual" within the meaning of Section 44 (b). The applicability of Section 44 had never been put in issue. Taxpayer's right to return part of the proceeds of the sale in years subsequent to the sale was not in issue. Taxpayer, in his own petition, did not allege that the profits of the sale were only returnable in the year of sale and yet he requested a motion for a judgment on the pleadings, based on the theory that any income returnable was returnable only in the year of sale.

In order to have rendered judgment on the pleadings, the Tax Court would have had to determine such matters as whether the profits from the sale of the patents were returnable in the years subsequent to the sale under Section 44 (b); whether they were so returnable under any other section of the revenue laws; if not, whether the taxpayer having elected to return the profits in the years subsequent to the sale could have at the time of the trial alleged that they were only returnable in the prior year. But these matters were not in issue between the parties. It is most important to keep in mind that taxpayer, in his petition for redetermina-

tion of the deficiency did not claim that the income was only returnable in the year of sale or conversely that none was returnable in subsequent years. It is therefore obvious that the Commissioner never intended to admit or deny anything in this respect. It is well settled that the pleadings filed with the Tax Court define and limit the issues which will be considered by that court. *Roberts* v. *Commissioner,* 19 B. T. A. 351; *Dastague* v. *Commissioner,* 19 B. T. A. 1324; *Popular Price T. Co.* v. *Commissioner,* 33 F. 2d 464 (C. C. A. 7th); *Hanby* v. *Commissioner,* 67 F. 2d 125 (C.C.A. 4th).

Taxpayer's contention, in short, was that the Commissioner by denying taxpayer's negative allegation not only admitted the affirmative but admitted by implication another ultimate fact which was not even in issue in the case.

Even assuming that the approach taken by taxpayer to reach his conclusion were not defective in its inception, his conclusion would nonetheless be untenable since the basic premise is false. Even if the Commissioner's pleadings amounted to an admission that the sale was not "casual", the income might still be returnable on an installment basis in the years involved under Section 44 (a) (Appendix, infra), which allows taxpayers, who regularly sell personal property on an installment basis, to report their income accordingly. As far as the pleadings were concerned, this section might have been applicable to taxpayer. In this connection it should be noted that taxpayer amended his pleadings to allege that he was not a dealer who regularly sold personal property on the installment basis, and this allegation was denied by the Commissioner. Since, as taxpayer so ardently contends, allegations which are denied must be deemed false for the purposes of a motion for judgment on the pleadings, it would follow that taxpayer's allegation that he was not such a

dealer as is described in Section 44 (a) must be deemed false and the income could have been returned in the years subsequent to the sale whether or not it was "casual". It should be noted in this connection that the Commissioner never admitted or denied the applicability of subsection (b) of Section 44 but admitted only that taxpayer elected to report the income under Section 44 (b).

Taxpayer in his argument has laid emphasis on the alleged inconsistency in the pleadings of the Commissioner. It is clear that as far as the pleadings went there was no inconsistency. It is also clear that the alleged inconsistency was between a matter not even in issue in the case and the purported implication of the Commissioner's denial of the taxpayer's negative allegation. At any rate, where the legal effect of a factual situation, or the proper interpretation of a statute is not clear, the Commissioner has no choice but to assert the liability arising from the several reasonable interpretations even though they be inconsistent. See *First Nat. Bank of Wichita Falls, Trustee* v. *Commissioner,* 3 T. C. 303; *Estate of Sanford* v. *Commissioner,* 308 U. S. 39.

The purpose of pleadings is to properly place the real issues in the case before the court. The pleadings in this case accomplished that objective and the court properly determined that since there were contested questions of fact essential to a determination of the case, a trial was necessary.

Over a century ago the Supreme Court laid down the beneficent rule, since adhered to, that courts should not decide a cause on a slip in pleading or the inadvertence of counsel except where some rule of law, the observance of which is essential to the administration of justice, requires it. *Sheehy* v. *Mandeville,* 11 Cranch

207. More recently the same Court stated in *Maty* v. *Grasselli Co.,* 303 U. S. 197, 200:

> Pleadings are intended to serve as a means of arriving at fair and just settlements of controversies between litigants. They should not raise barriers which prevent the achievement of that end.

In final analysis, taxpayer's contention is nothing but a supertechnical quibble which would have been of extremely doubtful validity even under the system of rigid common law pleadings.

CONCLUSION

The judgment of the Tax Court should be affirmed.

Respectfully submitted,

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APPENDIX

Internal Revenue Code: (as amended by Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798)

Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) *Trade or Business Expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *

* * * * * *

(2) *Non-Trade or Non-Business Expenses.*—In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.

* * * * * *

(26 U. S. C. 1946 ed., Sec. 23.)

Sec. 44. Installment Basis.

(a) *Dealers in Personal Property.*—Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

(b) *Sales of Realty and Casual Sales of Personalty.*—In the case (1) of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed 30 per centum of the selling price * * *, the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section * * *.

(26 U. S. C. 1946 ed., Sec. 44.)

Sec. 113. Adjusted Basis for Determining Gain or Loss.

* * * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General Rule.*—Proper adjustment in respect of the property shall in all cases be made—

(A) For expenditures, receipts, losses, or other items, properly chargeable to capital account, * * *

(26 U. S. C. 1946 ed., Sec. 113.)

Sec. 117. Capital Gains and Losses.

(a) *Definitions.—As used in this chapter—*

(1) *Capital Assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inven-

tory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1) ; * * *

* * * * * *

(26 U. S. C. 1946 ed., Sec. 117.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

Sec. 19.23(1)-7. *Depreciation of patent or copyright.*—In computing a depreciation allowance in the case of a patent or copyright, the capital sum to be replaced is the cost or other basis of the patent or copyright. The allowance should be computed by an apportionment of the cost or other basis of the patent or copyright over the life of the patent or copyright since its grant, or since its acquisition by the taxpayer, or in the case of a copyright, since March 1, 1913, as the case may be. If the patent or copyright was acquired from the Government, its cost consists of the various Government fees, cost of drawings, experimental models, attorneys' fees, development or experimental expenses, etc., actually paid. Depreciation of a copyright can be taken on the basis of the fair market value as of March 1, 1913, only when affirmative and satisfactory evidence of such value is offered. Such evidence should whenever practicable be submitted with the return. If the patent becomes obsolete prior to its expiration, such proportion of the amount on which its depreciation may be based as the number of years of its remaining life bears to the whole number of years intervening between the basic date and the date when it legally expires may be deducted, if permission so to do is specifically secured from the Commissioner. Owing to the difficulty of allocating to a particular year the obsolescence of a patent, such permission will be granted only if

affirmative and satisfactory evidence that the patent became obsolete in the year for which the depreciation has not been taken in prior years does not entitle the taxpayer to deduct in any taxable year a greater amount for depreciation than would otherwise be allowable.

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